# The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations

**July 2002**

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**DEPARTMENT OF THE TREASURY**

WASHINGTON, D.C. 20220

July 5, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Scott E. Wilson

FROM: (for) Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Does Not Always Address Subchapter S Corporation Officer Compensation During Examinations (Audit # 200130027)

This report presents the results of our review of the Internal Revenue Service's (IRS) Subchapter S Corporation Officer Compensation Examinations. The overall objective of this review was to determine if the IRS is effectively identifying taxpayers that are not reporting Subchapter S Corporation (S Corporation)[1] officer compensation.

In summary, S Corporations are corporations that elect to pass corporate income and losses to their shareholders for federal tax purposes. Shareholders of S Corporations report pro rata shares of income and losses on their own tax returns and are assessed tax at their individual income tax rates. S Corporations are to pay their officers a reasonable salary for personal services rendered. This salary is subject to the Federal Insurance Contributions Act (FICA)[2] tax of 15.3 percent (for Tax Year 1998). S Corporations sometimes avoid paying these FICA taxes by having their officers take compensation other than salaries, such as distributions of cash and property, or loans.

To evaluate the IRS' examinations of officer compensation, we reviewed 84 S Corporation cases, of which 58 had officer distributions. Examiners did not address officer compensation issues in their examinations in 13 (22 percent) of these 58 cases. In the cases we reviewed, the shareholders reported an average of only $5,300 of wages on the Wage and Tax Statement (Form W-2), while reporting an average distribution of $349,323 on the Analysis of Accumulated Adjustments Account,

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[1] An election to be an S Corporation permits the income from the corporation to be taxed to the shareholders rather than to the corporation. Shareholders which elect S Corporation status must also meet all the specific criteria outlined in the Internal Revenue Code, Sections 1361 and 1371.
[2] Federal Insurance Contributions Act, 26 USC, Section 3101.

Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (Schedule M-2).[3] We also determined that the IRS classifiers were unable to effectively identify and classify S Corporation officer compensation non-compliance because the IRS computer systems capture limited tax return data on S Corporations.[4] Also, better methods are needed to measure the results of the IRS' efforts to address S Corporation officer compensation compliance. Finally, the Taxpayer Education and Communication (TEC) function could improve its taxpayer outreach efforts regarding S Corporation compliance.

We recommend that the Director, Compliance, Small Business/Self-Employed Division, provide additional technical guidance to field personnel in determining reasonable officer compensation. The Director, Compliance, should submit a Request for Information Services (RIS) to include transcriptions of corporate distributions not presently captured from filed S Corporation tax returns. Additionally, the Director, Compliance, should submit a RIS to improve its process for measuring its efforts for working officer compensation cases, and the Director, TEC, should expand educational outreach activities, such as sending out pre-filing literature to taxpayers electing S Corporation status.

Management's Response

Management's response was due on July 1, 2002. As of July 3, 2002, management had not responded to the draft report.

Copies of this report are also being sent to IRS officials who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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[3] Schedule M-2 is a section of the U.S. Income Tax Return for an S Corporation (Form 1120S). All payments of cash and transfers of property to and from the shareholders during the tax year are reported in this section of the tax return.

[4] Classifiers manually screen tax returns to determine which returns should be selected for examination and what issues should be examined.

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## Background

A corporation is an artificial, legal person created under state law. It may be owned by one or more persons; is a separate entity that can acquire, hold, and convey property; can be sued; and generally acts in its own name. It derives its rights from statute and its own articles of incorporation. The corporation alone is responsible for its debts and liabilities. Its owners are not personally liable for these obligations.

A corporation can elect to become a Subchapter S Corporation (S Corporation) and, as a result, the corporation can pass its income and losses to its shareholders for federal income tax purposes.[1] Shareholders of S Corporations are required to report pro rata shares of the S Corporation's income and losses on their personal tax returns. Therefore, they are assessed tax at their individual income tax rates and avoid higher corporate tax rates.

The Internal Revenue Code includes officers of corporations within the definition of "employee." S Corporations should pay their officers a reasonable salary for personal services rendered. This compensation is subject to the Federal Insurance Compensation Act (FICA)[2] tax rate of 15.3 percent for Tax Year (TY) 1998.

In recent years, the Internal Revenue Service's (IRS) efforts to examine potentially non-compliant taxpayers have significantly decreased. From Fiscal Years (FY) 1996 to 1999, overall examinations fell by 49 percent. Conversely, during that same time frame, there had been more than a 13 percent growth in the number of S Corporation filings.[3]

The IRS' examination guidelines instruct tax examiners to be alert for S Corporation officers who perform services, but are compensated via means (such as distributions of cash

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[1] Shareholders that elect S Corporation status must also meet all the specific criteria outlined in the Internal Revenue Code (IRC), Sections 1361 and 1371.
[2] Federal Insurance Contributions Act, 26 USC, Section 3101.
[3] An Election by a Small Business Corporation (Form 2553) permits the income from the corporation to be taxed to the shareholders rather than to the corporation.

and property, or loans) other than salaries. Compensation via these other means avoids paying FICA taxes.

The issue of S Corporations not providing a salary to their officers has been a concern for the IRS. In June 1998, the Kansas-Missouri and Ohio District Offices of Research and Analysis conducted a study of S Corporation officer compensation. The study was initiated to identify and quantify causes of inadequate compensation to S Corporation officers. The study results indicated that a possible $284 million in employment tax might have been underreported for TY 1995. We did not attempt to validate the findings or national projections of non-compliance of this study.

We limited our analysis to U.S. Income Tax Returns for an S Corporation (Form 1120S) reporting little or no officer compensation and also listing distributions to shareholders in the Analysis of Accumulated Adjustments Account, Other Adjustments Account and Shareholders Undistributed Taxable Income Previously Taxed (Schedule M-2) of Form 1120S.[4] We conducted our audit at the Small Business/Self-Employed (SB/SE) Division Compliance Areas located in Philadelphia, Pennsylvania (Area 3); Baltimore, Maryland (Area 4); and Minneapolis/St. Paul, Minnesota (Area 9); and the Dayton Federal Records Center. Fieldwork began in July 2001 and was completed in March 2002. The audit was conducted in accordance with *Government Auditing Standards.* Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

## Examiners Do Not Always Ensure Cases Are Adequately Reviewed and Considered for Potential Officer Compensation Non-Compliance

In addition to determining such factors as shareholder duties, the IRS' examination guidelines require examiners to be aware of inadequate salaries paid to officers/shareholders who receive substantial nontaxable distributions. S Corporation earnings are not subject to employment tax, so officers/shareholders often receive little or no salary as compensation, to avoid paying employment taxes. When an

[4] Schedule M-2 generally reflects the accumulated undistributed and distributed net income of the corporation.

examiner determines that the taxpayer did not properly report payments from the S Corporation as wages, the examiner should make an assessment to the S Corporation's Employers' Quarterly Tax Return (Form 941).

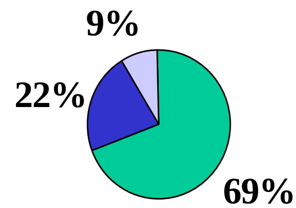
We judgmentally selected 84 S Corporation tax returns that had been examined by the IRS, and which reported officer compensation less than $10,000 and ordinary income[5] greater than $50,000. For these cases, the average wages reported on the Wage and Tax Statement (Form W-2) and on Form 1120S was $5,300, while the average Schedule M-2 distribution was $349,323. The $5,300 in wages is subject to FICA taxes, while the $349,323 is not. This disparity suggests continued S Corporation underpayment of reasonable salaries to the corporate officers and shareholders, thus avoiding paying the FICA tax.

Out of the 84 cases selected, we identified and reviewed 58 returns reporting distributions to determine whether the examiner addressed officer compensation or shareholder participation issues. In the other 26 cases, no corporate distributions were reported on the returns. The following chart shows that examiners did not always address officer compensation in cases reflecting little to no officer compensation, yet showing Schedule M-2 distributions.

[5] Ordinary Income is defined as profit from a trade or business.

### 58 Examined S Corporations With Distributions

- 40 cases (69 percent) contained appropriate examiner comments
- 13 cases (22 percent) contained no examiner comments
- 5 cases (9 percent) did not contain sufficient examiner workpapers for analysis




*Source: 58 Examined S Corporation Closed Case Reviews.*

In the 13 (22 percent) cases in which the examiner did not address the issue, the reported Schedule M-2 distributions on the returns were in excess of $12 million. The 13 case files did not contain adequate information necessary to estimate the actual amount of FICA taxes that should be reported on the Form 941. However, the amount that the examiner could have assessed as employment taxes to the shareholders could have been as high as $648,065, if the entire $12 million was misclassified as income and should have been classified as salary compensation to the officers and shareholders of the S Corporations.

One of the difficulties the IRS encounters in examining officer compensation is determining the amount of salary attributable to the level of shareholder services rendered to the corporation. Making reasonable compensation determinations is a complex and somewhat subjective endeavor. Of the three area offices visited, only one had access to any type of software that could assist examiners in determining a reasonable salary in officer compensation examinations. This software provides salary information from a variety of occupations throughout the country. Such applications are one type of research tool that examiners can use to make appropriate and reasonable officer salary determinations. It is critical for the examiner to determine the level of services provided by the shareholder before an allocation of officer compensation can be made.

### Recommendation

1. The Director, Compliance, SB/SE Division, should provide technical guidance and resources (such as software) to field personnel to aid in determining reasonable officer compensation.

Management's response: Management's response was due on July 1, 2002. As of July 3, 2002, management had not responded to the draft report.

### Classifiers Are Unable to Effectively Identify and Classify S Corporation Tax Returns With No Officer Compensation

The Examination function's goal is to conduct quality, cost effective audits of tax returns to determine whether the substantially correct amount of taxes has been reported. To accomplish this goal, examiners in field offices conduct a manual review process, called "classification," to determine which returns should be selected for examination, what issues should be examined, and how examinations should be conducted. This process is labor intensive and time consuming since it requires the examiner, called a classifier, to individually inspect hundreds of S Corporation tax returns for Schedule M-2 distributions and for loans to or from shareholders. Those returns without distributions or corporate loans to/from shareholders are not classified for examination. In other words, the current process is extremely inefficient. However, there are alternatives to this manual process.

The IRS has a database known as the Midwest Automated Compliance System (MACS), which contains certain information for various types of tax returns. The database is created when IRS employees input certain line items of the tax returns into the IRS' computer system used to process the returns. Classifiers can then use this database to identify certain aspects (line items) on the tax returns. However, because of the costs involved, not all line items are input to the computer system, so they are not included in the MACS. One such unavailable item is corporate distributions, which is reported on Schedule M-2.

Management in two of three area offices we visited used locally developed criteria for evaluating MACS data to identify potential non-compliant Forms 1120S. While the use of the MACS is somewhat beneficial, it has limited data for use by the examiners. The remaining office did not use the MACS at all for this purpose. This inconsistency between area offices may result in a disproportionate number of taxpayers being examined based on geographic location.

As stated earlier, officers/shareholders may circumvent employment tax liabilities by taking a small wage and receiving the remaining corporate profit as a tax-free distribution or loan. In our review of 84 tax returns, 58 tax returns (69 percent) reported corporate distributions on the Form 1120S, Schedule M-2. In addition, loans either to or from shareholders were reported in 43 (51 percent) of the cases. It is important that the examiner have immediate electronic access to distribution and loan information to efficiently classify Form 1120S tax returns for possible officer compensation non-compliance. Without it, the examiner must physically review each Form 1120S for distributions or loans to shareholders.

To determine the extent of potential non-compliance in officer compensation for TY 1998, out of the 2.6 million S Corporation tax returns filed, we identified 126,559 (5 percent) which reported less than $10,000 of officer compensation on the Form 1120S and also reported ordinary incomes greater than $50,000. To identify distribution or loan information from these 126,559 tax returns, the classifier would have to physically review each tax return for distribution and loan information. These tax returns could be more efficiently and cost effectively identified for examination if the information was available on the MACS. Returns could then be more efficiently selected for examination, which would improve the compliance level of officer compensation on Form 1120S tax returns.

## Recommendation

2. The Director, Compliance, SB/SE Division, should submit a Request for Information Services (RIS) that

would require the corporate distributions on the Schedule M-2 to be input to the IRS' computer system during returns processing, and therefore available to the MACS database. Classifiers should then use the MACS when classifying Form 1120S returns.

**Better Methods Are Needed to Measure Results of S Corporation Compliance Efforts**

One of the goals of the IRS is to establish risk-based compliance approaches that ensure long-term solutions to existing compliance challenges. To determine whether it is succeeding, management should measure progress towards the goals.

Presently, no established national process is in place to consistently measure S Corporation compliance efforts. Adjustments resulting from Form 1120S officer compensation examinations are typically made in the assessment of additional tax to one of the subject S Corporation's employment tax returns (i.e., Form 941).

The Examination Operational Automation Database (EOAD) is the primary tool used by management to monitor compliance performance. However, the system does not track examination adjustment assessments made to Form 941. No other system can readily track the results of officer compensation examination issues. As a result, management does not have sufficient information to make informed decisions about the effectiveness of compliance initiatives in this area.

## Recommendation

3. The Director, Compliance, SB/SE Division, should submit a RIS to existing (and/or future) information systems (such as the EOAD) to identify officer compensation-related adjustment assessments made to S Corporation employment tax accounts.

**Taxpayer Outreach Efforts Regarding S Corporation Compliance Could Be Improved**

The Taxpayer Education and Communication (TEC) function of the SB/SE Division is responsible for educating and informing taxpayers and representatives about tax obligations by developing educational products and services focused on customer needs. One area where such education and information is needed is in the reporting of officer compensation by S Corporations. A study conducted by the

Kansas-Missouri and Ohio District Offices of Research and Analysis showed that officers of S Corporations are not always aware they should be reporting a salary for services provided to the S Corporation because they pay income taxes on the distributions claimed on their personal U.S. Individual Income Tax Return (Form 1040).

Written pre-filing information related to S Corporation officer compensation is generally limited to a brief mention in the S Corporation tax preparation instruction booklet and what is available via the IRS' Web site. Although area offices provide Small Business Workshops to the business community on a variety of subjects, the level at which officer compensation is discussed varied between the three area offices we visited. For example, one area office is actively scheduling Tax Practitioner seminars that will specifically address officer compensation. The other two offices will discuss the issue only if requested during the Small Business Workshop.

The TEC function is currently focusing its resources on taxpayers filing incorrect S Corporation elections. Although the IRS considers S Corporation elections to be important, the TEC function must also consider the level of compliance and tax implications of not reporting officer compensation. While some taxpayers deliberately try to circumvent tax laws, many do not comply with the laws because the laws are complex and the taxpayers do not understand them. Without an effective education program, some taxpayers will continue to inadvertently not comply with tax laws. Providing pre-filing information to officers/shareholders regarding the requirement to provide a salary for services performed would have a positive impact on educating taxpayers early in the process, thus decreasing the chances for future filing errors.

## Recommendation

4. The Director, TEC, SB/SE Division, should develop consistent materials for educating and informing taxpayers and representatives of their S Corporation officer compensation tax obligations. Such materials

could include sending out pre-filing literature to taxpayers electing S Corporation status.

**Appendix I**

## Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) is effectively identifying taxpayers that are not reporting Subchapter S Corporation (S Corporation)[1] officer compensation.

Scope and Limitations of Case review:

A major portion of our audit involved a review of closed Examination cases. We used judgmental sampling because of limitations in the IRS' data meeting our specific search criteria. The nationwide sample included S Corporation cases closed by the Examination function from Fiscal Year (FY) 1999 through the first quarter of FY 2001. The details of our methodology are contained in Audit Tests II. A and II. B below.

In order to accomplish our overall objective we completed the following objectives and performed the following tests:

I. Determined whether the Small Business/Self-Employed (SB/SE) Division Headquarters effectively provides oversight and monitors U.S. Income Tax Return for S Corporations (Form 1120S) compliance issues.

II. Determined whether examiners properly commented on officer compensation or shareholder involvement in examined 1998 S Corporations by reviewing case file workpapers. We judgmentally selected a nationwide sample of closed examined S Corporations with the highest-risk for error and reflecting less than $10,000 in officer compensation and having ordinary income greater than $50,000. The filing date for the 1998 U.S. Income Tax Return for an S Corporation (Form 1120S) is typically in Calendar Year (CY) 1999 and therefore would not have been eligible for examination until approximately CY 2000. As a result, we selected CY 1998 to ensure the highest possible population of closed examined cases.

   A. Obtained a nationwide population of filed Tax Year (TY) 1998 Forms 1120S reporting less than $10,000 in officer compensation on line 7 of Form 1120S and greater than $50,000 on line 21, and a nationwide population of closed examined S Corporations between FYs 1999, 2000, and the first quarter of FY 2001. (Total 385 cases)

[1] An Election by a Small Business Corporation (Form 2553) permits the income from the corporation to be taxed to the shareholders rather than to the corporation.

B. From a universe of 385, we used a random number generator to select our sample. We requested 102 cases on the Integrated Data Retrieval System (IDRS)[2] for our sample. (Received 84 cases)

C. From a universe of 385 examined TY 1998 Form 1120S tax returns, we reviewed the 84 cases for Schedule M-2 distributions and loans to or from shareholders to determine if the examiner commented on officer compensation or shareholder involvement.[3]

III. Determined whether the National Headquarters is providing outreach (pre-filing) information to taxpayers regarding officer compensation reporting requirements.

[2] The IDRS is the main database of taxpayer accounts. It is used by IRS personnel to research and update taxpayer account data.
[3] Schedule M-2 is a section of the S corporation annual tax return. All payments of cash and transfers of property to and from the shareholders during the tax year are reported in this section of the tax return.

**Appendix II**

## Major Contributors to This Report

Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs)
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Gary Swilley, Audit Manager
Joseph F. Cooney, Senior Auditor
James Mills, Senior Auditor
Cristina Johnson, Auditor
Mildred Woody, Auditor

## Appendix III

## Report Distribution List

Commissioner  N:C
Deputy Commissioner  N:DC
Deputy Commissioner, Small Business/Self-Employed Division  S
Director, Centralized Workload and Selection Development, Small Business/Self-Employed Division  S:C
Director, Compliance, Small Business/Self-Employed Division  S:C
Director, Taxpayer Education and Communication, Small Business/Self-Employed Division  S:T
Chief Counsel  CC
National Taxpayer Advocate  TA
Director, Legislative Affairs  CL:LA
Director, Office of Program Evaluation and Risk Analysis  N:ADC:R:O
Office of Management Controls  N:CFO:F:M
Audit Liaison:  Commissioner, Small Business/Self-Employed Division  S

**Appendix IV**

## Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Increased Revenue - Potential: $648,065 (see page 2).

Methodology Used to Measure the Reported Benefits:

**General Population Information**

We obtained the nationwide population of U.S. Income Tax Returns for S Corporations (Form 1120S) closed by the Examination function during Fiscal Years 1999, 2000, and the first quarter of 2001. We also obtained a nationwide population on Forms 1120S filed in Tax Year (TY) 1998 with the following criteria – Forms 1120S reporting:

- Less than $10,000 of officer compensation on line 7; and
- Ordinary income of greater than $50,000 reported on line 21.

We merged the two databases to obtain a population of examined 1998 Forms 1120S with the criteria listed above. Although we would have preferred to limit our population to Small Business/Self-Employed Division taxpayers, we were unable to do so because in TY 1998, the Internal Revenue Service had not yet reorganized; and, therefore, its database was not set up for such inquiries tailored to taxpayer segments.

**Outcome Measure - $648,065**

Of the 84 cases reviewed, we determined in 13 cases with Schedule M-2 distributions and officer compensation of less than $10,000, the examiner did not comment on officer compensation or shareholder participation. Out of the 42 shareholders represented in the 13 cases identified, 34 received less than the maximum Federal Insurance Contributions Act (FICA)[1] wage rate of $68,400 for Calendar Year (CY) 1998. The total distributions for the 13 cases is $12,403,123. Although there is a limit on the amount of wages subjected to social security taxes of 12.4 percent, there is no limit on the amount of wages subject to Medicare taxes of 2.9 percent. We calculated the maximum potential FICA tax for the 13 cases as follows:

[1] Federal Insurance Contributions Act, 26 USC, Section 3101.

| | | | |
|---|---|---|---|
| A. | Maximum FICA Wage Rate for 1998: | $68,400 | |
| | Multiplied by number of shareholders: | 34 | |
| | Total: | $2,325,600 | |
| | Multiplied by FICA Rate: | 12.4 % | |
| | Total: | | $288,374 |
| B. | Total Schedule M-2 Distributions: | $12,403,123 | |
| | Multiplied by FICA (Medicare Rate) | 2.9% | |
| Total: | | $359,691 | |
| | Maximum potential employment tax which could have been assessed: | | $648,065 |
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